Switzer Super Report

Issue 110, 16 August 2012

Going up!

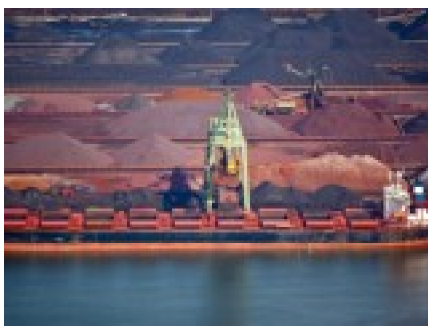
Wall Street had another do-nothing session last night as investors wait not only for the European Central Bank (ECB) to do something in early September but also a possible third round of stimulus from the US Federal Reserve. Locally however, stocks are up again as good earnings results roll in.

Charlie gives you his thoughts on Commonwealth Bank after its 'dividend surprise' yesterday. Meanwhile, I tell you about how investing in an exchange-traded fund helped me out of a bind. Paul Rickard analyses Crown's new 'hybrid' fixed-interest security and Ron Bewley reveals which resource stocks he owns and why the sector is making a comeback. Plus, Andrew Bloore explains why you can't run your SMSF while living overseas. Have a great day!

Sincerely,

Peter Switzer

Inside this Issue



You haven't missed the resource stock boat just yet
by Ron Bewley
08

02 **An ETF saved me from Russian Roulette**
by Peter Switzer
Taking advantage of a rising index.

03 **Charlie's going all the way with CBA**
by Charlie Aitken
The bank has just announced a record profit and high dividend.

06 **Should you bet on Crown's new security?**
by Paul Rickard
An attractive interest rate, but read the fine print.

08 **You haven't missed the resource stock boat just yet**
by Ron Bewley
Three resources stocks Ron Bewley owns.

10 **Think twice before living overseas**
by Andrew Bloore
Your fund could be made non-complying.

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.

An ETF saved me from Russian Roulette

by Peter Switzer

One of the scariest propositions you can deal with as a financial adviser is to play around with the timing of a stock market. And one of the rules of thumb or maxims of our game is that it's 'time in the market', not 'timing the market', that's important.

Wrapping it up

Recently we had a new client who came from a situation where he was on a wrap platform that didn't suit his new circumstances, goals and appetite for risk. In addition, we could see he would be charged lower fees by using a self-managed super fund (SMSF) and so that was our recommendation.

We also wanted to tweak his portfolio so that it was less risky, more dividend-oriented and a better reflection of his new attitude to risk. This guy had been an entrepreneur with an aggressive investment stance and was now someone wanting steady growth and a lot more sleep-at-night security.

A wrap account allows you to control all your investments within one account – even if they come from a number of different providers. One of the challenges of disentangling from a wrap and then reworking a portfolio is that it can take time, but time can be your friend if you cash out a portfolio on a wrap to reconstruct one for a SMSF.

The problem

Now our predicament came on July 26 when Mario Draghi – the European Central Bank (ECB) boss – decided to positively shock global financial markets with his "whatever it takes" promise to save the euro. From that date, the S&P/ASX200 index rose from 4,123.9 to 4,312.6 by August 8, which was a 4.6% move and on a portfolio of around $2 million. That was a potential $90,000 loss if we had our client out of the market for too long.

The solution

Thankfully, nowadays products such as exchange traded funds (ETFs) that track the index are available and an ETF became a default position until we were in a position to put the new portfolio together.

Personally, I'm concerned about ETFs that are derivatives as they could be risky and I'm not sure if everyone who uses them is aware of the potential problems that could go with these instruments for 'sophisticated investors'.

On the other hand, ETFs that buy the underlying securities have a lot of appeal because the product-makers actually buy and hold the relevant 200 stocks when you put your money into an ETF that tracks the S&P/ASX200 index. You also get the associated dividends that would go with these stocks.

These are a good product innovation and can be used to help SMSF trustees create a diversified portfolio of investment assets. They can also help an adviser out of a tight and potentially risky situation, where a $90,000 gain looks a lot better to a client than $90,000 that never was!

Find out more about ETFs on our website by reading What is an ETF? *or* JP Goldman's recommendations.

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Charlie's going all the way with CBA

by Charlie Aitken

The Commonwealth Bank (CBA) clearly ticked one important box in my bullish Australia call yesterday. The CBA result was a test for CBA and the ASX200 as a whole. Not only did CBA pass that test, they scored top marks in my opinion, justifying their own premium rating and also producing some stunning ratios that must leave top-down Australia bears scratching their heads.

For all the sensational 'BS' written on Australian housing and potential bank debts over the past year, CBA lost just $107 million on a total mortgage portfolio of $343 billion. That's a loss rate of just 0.03%, which would have to be the lowest in the global mortgage banking universe.

That low mortgage loss rate was achieved in a period of falling employment and falling house prices. Yet now we have entered a period of rising employment and rising house prices due to the impact of lower mortgage rates, higher rents and housing underbuild.

It's Australia, mate

I have written hundreds of times over the years that foreign investors don't understand the Australian psyche when it comes to home ownership. This isn't the US where you just hand the keys back to the bank if you can't pay the mortgage; in Australia the bank effectively owns you and the ramifications of declaring bankruptcy are draconian and also come with a social stigma.

This is why Australian households will sacrifice all forms of discretionary spending to service their mortgage. They will also take on second jobs to service their mortgage, which in my view makes Australian mortgage banks the lowest risk in the world. This theory has been proven time and time again in respect to Australian mortgage banks where loan losses NEVER reach the levels the doomsayers say.

The proof

Just have a look at this slide from the CBA results pack, remembering CBA is Australia's largest mortgage lender.

Home loan portfolio profile

Portfolio	Jun 12	Quality	Jun 12
Total Balances - Spot ($bn) [1]	351	Total Balances – Avg YTD ($bn) [1]	343
Total Accounts (m)	1.4	Actual Losses YTD ($m) [1,3]	107
Fundings ($bn) [2]	54	Loss Rate (%) [1,2]	0.03
Variable Rate (%)	87	LVR – Portfolio Avg (%) [4]	44
Owner-Occupied (%)	58	Customers in advance (%)	68
Investment (%)	33	Payments in advance (#)	7
Line of Credit (%)	9	Low Doc % of Book	2.7
Proprietary (%)	62	FHB - % of new fundings [2]	14
Broker (%)	38	FHB - % of balances	15
Average Loan Size ($'000)	221	LMI - % of Book	25
Annual Run-Off (%) [2]	17	Serviceability buffer (bpts)	150

Keep these stats in mind: 58% of CBA's mortgage book is owner-occupied, 87% is at variable rates, the average loan-to-value ratio is 44%, the average loan size is $221,000, 68% of all customers have made payments in advance of schedule, averaging seven payments in advance, while only 2.7% of the entire book is low documentation loans.

Is it therefore a surprise that the loan loss rate is only 0.03%? It shouldn't be because this is all about credit quality and conservative mortgage lending which is 63% funded from CBA's deposit base and generates a net interest margin (NIM) of 2.1%, which spits out high free cash that in turn is returned to shareholders in the form of high fully franked dividend streams.

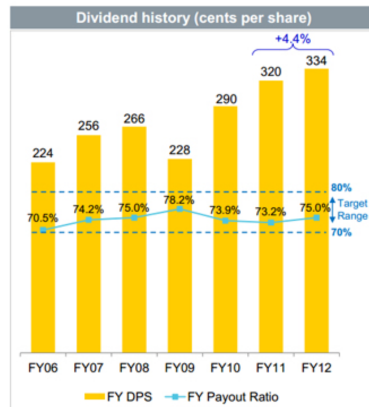
Look at the dividend

CBA clearly delivered a final dividend surprise

yesterday of 197 cents, but more importantly for shareholders, they revised their dividend payout policy as the table below confirms.

Dividends

- Revised dividend policy
  - Recognition shareholders want payout ratio optimised
  - Maximise use of franking account balance
- Target payout ratio 70-80%
- Interim dividend will increase to approximately 70% of interim profit
- DRP continuing, but with no discount
- Subject to credit growth/capital usage, dilutive impact of DRP may be minimised in future by on market purchase of shares for DRP



49 CommonwealthBank

The interim dividend increasing to "approximately 70% of the interim profit" is a positive development. Our analyst TS Lim currently forecasts the bank's earnings per share in the first half of fiscal 2013 to be 233 cents, which would equate to an interim dividend in February 2013 of 163 cents.

You can still get the dividend

CBA is 'cum' the final dividend of 197c until Friday, which means the company will pay shareholders who buy CBA before the close of trade on Friday 360 cents fully franked in dividends over the next seven months. That is a 6.44% fully franked yield for seven months, a return that beats cash at the bank again!

If you look out 13 months, you can collect the 197-cent full-year dividend just announced, plus another 360 cents over the 2013 financial year, taking the 13 month yield to 9.9% fully franked. Collecting $5.57 fully franked in dividends from CBA over the next 13 months is clearly attractive.

You will read page after page of minutia analysis of the CBA result this morning. In my opinion, pretty much all of it is useless with the only variables to focus on being the two slides above.

While not cheap, on next year's numbers CBA isn't expensive either relative to the return on equity (ROE). In the 2013 financial year, we see CBA's earnings per share (EPS) growing 5%, while dividend per share (DPS) jumps to 347 cents for a prospective yield of 6.2% fully franked. I tend to think that's an appropriate yield for the strongest bank in the strongest country in the Organisation for Economic Cooperation and Development (OECD). The price to earnings ratio (P/E) is 11.9-times fiscal 2013 and the Price to Book two-times. Those ratios are also justified.

Isn't it ironic

So when you are next at a dinner party and there's a grey nomad gloating how much cash they are holding, tell them that the Commonwealth Bank just reported a record profit and paid a record dividend because they are making a 2.14% net interest margin out of holding their cash!

The one-year total return (pre valuing franking credits and pre today's final dividend) in CBA shares is 16%, three times what your cash on deposit just paid you at CBA! And you can also tell them CBA shares are now only 10% below their all-time high of $62.16. Cash is king, hey?

Quality is NEVER cheap and I suspect CBA will test that all-time high over the next 12 months. That is particularly likely if we get some long overdue credit growth and a new home construction cycle as domestic confidence improves ahead of a change of federal government.

Note well, business confidence readings surged in Australia in July, all part of the underlying recovery in confidence I can feel building in Australia. That confidence will be helped by CBA today reminding all Australians (and offshore bears on Australia) we are the strong, not the weak.

Go Australia!

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Should you bet on Crown's new security?

by Paul Rickard

Casino operator Crown Limited has joined the rush to issue ‘hybrid’ securities with its announcement of a new $400 million issue with a ‘headline grabbing’ interest rate. But how will this security – a mesh of fixed-interest and shares – stack up to other hybrids in this expanding space, and should your super fund buy it?

Background

Crown is an ASX top 50 company with a market capitalisation of $6.2 billion. Its principle interests are the Crown Entertainment Complex in Melbourne and the Burswood Casino in Perth. It also owns a casino in London and has an approximate one-third share of Melco Crown, the owner and operator of casino resorts in Macau. Crown recently acquired 10% of its listed rival, Echo Entertainment Group.

Crown says it intends to use the proceeds from the sale for ‘general corporate purposes’ and ‘ongoing capital management’.

The details

Hybrid securities differ depending on the issuer, but they generally offer investors the opportunity to buy a security that pays interest for a set period of time, after which investors may have the option to either convert the security to an ordinary share or sell the security back to the issuer.

The Crown Notes will pay interest quarterly on a floating rate basis at a ‘headline grabbing’ rate of five percentage points above the 90-day bank bill rate. With the 90-day bank bill at around 3.6%, this implies an interest rate of 8.6% per annum for the first quarter.

Crown is currently rated BBB by Standard and Poor’s, and Baa2 by Moody’s. These ratings are one notch above the minimum investment grade rating. The new Notes are yet to be rated, but Crown expects that up until the first call date in six years’ time (which is the earliest date the company may choose to redeem, or buy back, the securities) they will be classified as ‘intermediate equity’ by the ratings agencies. This means they will qualify as 50% equity when used by the rating agencies to assess the strength of Crown’s balance sheet, and for investors, it means features such as a very long term (like 60 years!) and the right for Crown to defer the payment of interest.

The notes are subordinated and unsecured and rank behind all senior obligations and unsecured creditors, but ahead of Crown’s ordinary shareholders. Put simply, they carry a higher risk than straight fixed-interest investments, but are lower risk than ordinary shares.

Interest payments can be deferred at the director’s option, however interest deferrals are cumulative and compounding and a dividend ‘stopper’ applies to the payment of dividends on Crown ordinary shares.

Interest payments must also be mandatorily deferred if Crown’s leverage ratio (defined as gross debt divided by earnings before interest, tax, depreciation and amortisation (EBITDA)) exceeds 5.0 on two different testing dates, or Crown’s interest cover ratio falls below 2.5. Neither look like being breached at this point. At the end of June, Crown’s leverage ratio was 2.1 and the interest times cover ratio was 7.2.

What are the chances of these ratios breaching their levels? Crown estimates that gross debt could increase by around 40% from around $1.5 billion to $2.1 billion and normalised earnings could fall by around 60% before the leverage ratio cap is exceeded. The interest cover ratio can withstand more material changes.

Details of the issue are as follows:

Issue Size	$400m, with right to accept more or less
Security Type	Subordinated, unsecured, cumulative notes
Listing	ASX, stock code CWNHA, expected 17 September
Issue Price	$100 per Note
Term	60 years, maturing14 September 2037
Call Date by Crown	14 September 2018 (6 years), and then on every interest payment date
Step Up Margin	1.0% if not redeemed by 14/9/38 (26 years' time)
Interest	Paid quarterly on 14 December, 14 March, 14 June, 14 September
Interest Rate	90 Day Bank Bill +5.00%
Interest Payments	Crown can optionally defer. Also mandatory deferral. Dividend stopper. Payments are cumulative and
Ranking	Behind all senior obligations and unsecured creditors, ahead of ordinary Crown shares
Offer Opens	21-Aug
Offer Closes (scheduled)	5 September (General & Shareholder), 13 September (Broker firm)
Issue Date	14-Sep-12
Minimum Subscription	$5,000 or 50 Notes, then in multiples of $1,000 or 10 Notes

The institutional book build on Friday will set the final margin, which is expected to be 5.0%.

Our View

On a pricing basis, a margin of 5% looks pretty attractive. Caltex, which is rated one notch higher at BBB+, priced its recent issue at a margin of 4.5% and this was comfortably swallowed by the market.

But take note of the finer details. The call date on the Crown Notes is six years – one year later than most other issues. They 'nominally' mature in 60 years, and the step up date (when the margin would increase by a further 1%) is 26 years away!

The product disclosure statement (PDS) notes that Moody's and/or Fitch might continue to give these Notes some form of 'intermediate equity' weighting past the first call date, although Standard & Poor's has indicated that it won't.

Couple this with a company that has some fairly ambitious growth plans, and the bottom line is that an assumption that the Notes will be redeemed after six years is no foregone conclusion – there is an extra longevity risk with these Notes.

The positive news for yield hungry investors is that James Packer's private company, Consolidated Press Holdings, has stated that it intends to subscribe for $100 million of the Notes. So, if that is taken as a comfort factor, this investment probably makes sense within a diversified portfolio of hybrid securities.

At the indicated $400 million issue size, secondary market liquidity on the ASX is not going to be as strong as some other issues – so this Note is 'nibble' territory rather than one to load up on.

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

You haven't missed the resource stock boat just yet

by Ron Bewley

Last Tuesday, my long-held view that resources and related stocks had been oversold this year on a misguided end-of-China-boom story got some very strong backing. I publish a number of charts on my website each week, one of which shows my measure of under or overpricing – I call this 'exuberance'.

For a number of months, that measure has shown resource and related stocks to be very cheap while most of the defensive and high-yield stocks have been expensive.

In particular, my measure of exuberance for Telcos was 12% overpriced when I was interviewed last week on Switzer TV. Since I have observed that sectors don't typically stay overpriced by more than 6% for long before they correct, Telcos were defying gravity and I said that to Peter. Not only have I developed this rule over seven years and 11 sectors of the ASX200 – the same rule seems to work for the S&P500 and its sectors, which I also monitor.

Three stocks I own

I've stressed in previous articles the importance of only having a small number of stocks on my radar – about 25 – so I can follow them in detail. I currently own only 14 stocks, of which three are in Mining Services (part of the Industrials sector): **Boart Longyear (BLY)**, **Bradken (BKN)**, and **Emeco (EHL).**

I chose them because they had excellent consensus ratings from Thomson-Reuters (see my column What not to buy) and maintained those ratings through the last few months' sell-off in resource and related stocks.

I'm currently very overweight in resources because of the very strong forecasts of total returns, which I derive again from Thomson-Reuters data on dividend and earnings forecasts. Finally, that sector has been very cheap by my exuberance measure for some time.

Earnings season

I was not tempted to sell any of these stocks as they fell in price from an autumn peak that followed the very strong run from late 2011. Boart Longyear fell 41% from its 2012 high to its recent low, Bradken fell 52% and Emeco fell 33%.

Bradken came out with a 15% increase in profit last Tuesday, but more importantly, it stated that its order book was full. That positivity isn't the stuff of a China-gone-wrong story. As a result, Bradken opened on Tuesday morning about 9% up over the Monday close. Over the course of the week, shares in Boart Longyear and Emeco (although they have not yet reported) rallied hard in sympathy with Bradken.

Moving on up

Last week the ASX200 rose 1.3%, but Boart Longyear's price rose by 17%, Bradken by 24% and Emeco by 16%! My two mid-cap iron ore miners followed suit: Atlas' price rose 10% and Mount Gibson's by 7%. And Telstra? Down 6% on that week.

In my opinion the switch from defensives to cyclicals has been on for some time. I sold all of my **CSL (CSL)** and **Sonic Healthcare (SHL)** when that sector was overpriced by about 6% a few months ago – according to my measure of exuberance – and I popped some of the proceeds into **Rio Tinto (RIO)** and the rest in cash. I held on to my **Cochlear (COH)** (my only remaining Healthcare stock) for reasons I stated back in October when it suffered a sharp fall on its recall last year.

You haven't missed the boat

I don't think it's too late to get into the cyclicals if you choose carefully! But I'm glad I didn't sell because I may not have got back in again quickly enough. I don't pretend to have all of the best stocks in my portfolio, but I'm very happy with the ones I have and will ride the wave up if, indeed, my expectations are fulfilled.

What I have tried to show in this column is that there is a lot more to managing a portfolio than choosing a handful of stocks and lying-in-wait. For example, two other mining services companies reported on Monday 13 August: **Downer EDI (DOW)** gained 11% on the day while **UGL (UGL)** lost 11%.

Not all stocks are the same. In my thinking, managing a portfolio is difficult and time consuming. Certainly, investors need to "know when to hold 'em, know when to fold 'em," as Kenny Rogers once sang. I hung onto those three resources stocks based more on what the brokers thought rather than my own opinion, although, as I have stated before, I'm prepared to veto stocks that don't fit my thinking.

When I have a set of stocks that fit my view on how many stocks to own, which sectors are strong, and which sectors have reasonable levels of expected volatility, I can invest and watch without too much heartache. But market conditions do evolve; I monitor my portfolio daily, but only make changes when I think I have to – but that is not very often.

Ron Bewley is the executive director of Woodhall Investment Research.

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Think twice before living overseas

by Andrew Bloore

It's becoming increasingly popular in this globalised world to be offered work overseas and while there are many benefits to heading offshore for a while, the one thing it won't benefit is your self-managed super fund (SMSF). Put simply, you can't run an SMSF while 'living' overseas.

It's not necessarily a reason to stay put in Australia, but it highlights the need to plan what you intend to do with your super wisely.

SMSFs enjoy generous tax concessions provided they meet specific rules and maintain their investments and dealings according to super legislation. A core feature is that it must be a 'complying super fund', which means that it meets the 'residency test', and doesn't breach the super legislation or its trust deed during the year.

Why is SMSF residency important?

If the SMSF fails the residency test at any time, it becomes non-compliant. The market value of the fund's assets (less non-concessional contributions) will be included in the assessable income of the SMSF and taxed at the highest marginal tax rate. This will be the case for each year the SMSF remains non-complying.

Let's take a look at what the residency test involves.

Passing the residency test

The SMSF must be an Australian superannuation fund by meeting all three of the following conditions:

1. The SMSF is established in Australia or any asset of the fund is situated in Australia

A superannuation fund is established in Australia if the initial contribution made to establish the fund is paid to and accepted by the trustee of the fund in Australia. However, it isn't necessary to sign and execute the fund's deed in Australia.

Once it's determined that a fund was established in Australia, it will satisfy this test at all times. The fact that no asset of the fund is situated in Australia doesn't affect this conclusion.

If the SMSF wasn't established in Australia, it will still satisfy this test if at least one asset of the fund is situated in Australia at the relevant time. The location of an asset is determined by the type of asset and the common law rules for determining the location of assets.

2. The central management and control (CM&C) of the fund are ordinarily located in Australia

CM&C refers to strategic and high-level decision making and activities of the fund, such as formulating the investment strategy and reviewing investment performance. Operational or administrative tasks don't constitute CM&C. If you're living overseas for an extended period of time, chances are you'll be making these decisions overseas as well – that is, you won't pass this test.

However, the trustee will only be exercising the CM&C of the fund if the trustee actually performs the high-level duties in practice. If the trustee delegates the activities to another person who performs them without influence from the trustee overseas, then that person is seen to be exercising CM&C of the fund.

The legislation uses the word 'ordinarily'. The CM&C of the SMSF is regularly or usually in Australia if there is continuity or permanence. Temporary exercise of CM&C won't prevent it from being ordinarily in Australia at a particular time.

As a rule of thumb, 'temporarily' is seen as a period of no more than two years. However, individual SMSF circumstances, such as the intention of absence defined in advance or a change in situation, can determine whether the CM&C is ordinarily in Australia.

3. The fund has no active members, or active members who are Australian residents hold at least 50% of:

- the total market value of the assets attributable to super interests; or
- the sum of the amounts that would be payable for active members if they leave the fund.

A member is an active member of a superannuation fund at a particular time if the member is a contributor to the fund at that time or is an individual on whose behalf contributions have been made.

A member isn't an active member of the fund if:

- the member is a foreign resident, and
- the member is not a contributor at that time, and
- the only contributions made to the fund on the member's behalf since the member became a foreign resident were made in respect of a time when the member was an Australian resident.

What to watch out for

SMSF members travelling overseas should obtain advice on how to maintain SMSF residency during their absence from Australia.

Considerations may include delegating independent CM&C to a person in Australia to ensure that the CM&C continues to be exercised in Australia. Documenting the intention of temporary absence, the length of time outside of Australia, and the extent to which Australian assets have been divested will assist in determining whether the CM&C test is satisfied.

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Don't miss this!

Earnings season is still underway. These companies are set to report tomorrow and Monday.

Friday 17 August: Duet Group (DUE)
Friday 17 August: Treasury Wine Estates (TWE)
Friday 17 August: Nuplex (NPX)
Monday 20 August: Bendigo Bank (BEN)
Monday 20 August: Bluescope Steel
Monday 20 August: MacMahon Holdings (MAH)
Monday 20 August: Challenger Financial (CFG)
Monday 20 August: Fleetwood Corp (FWD)
Monday 20 August: Imdex (IMD)

Did you know?

It may sound incredibly boring, but tax planning for your SMSF can save you a lot of money. Hear what SMSF auditor Jo Heighway has to say on the subject on Super TV.